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No. 86-1440

In the Supreme Court of the United States

OCTOBER TERM, 1986

MONSOUR MEDICAL CENTER, PETITIONER

v.

OTIS R. BOWEN, SECRETARY, DEPARTMENT OF HEALTH AND HUMAN SERVICES, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the court of appeals correctly held that the Secretary was not collaterally estopped in federal administrative and judicial Medicare reimbursement proceedings by a prior decision on a similar issue in a state court case, when the state litigation was brought by Blue Cross in its capacity as private insurer, not in its capacity as Medicare "fiscal intermediary," and when the Secretary did not participate in or control the Blue Cross suit.

2. Whether the Secretary's denial of Medicare reimbursement for capital costs associated with the conversion of a private hospital into a non-profit hospital is supported by substantial evidence.

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BRIEF FOR THE RESPONDENTS IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A21) is reported at 806 F.2d 1185. The opinion of the district court (Pet. App. A22-A34) is reported at [1986-1 Transfer Binder] Medicare & Medicaid Guide (CCH) ¶ 35,083. The opinion of the Provider Reimbursement Review Board (Pet. App. A36-A66) is reported at [1984-2 Transfer Binder] Medicare & Medicaid Guide (CCH) ¶ 34,138.

JURISDICTION

The judgment of the court of appeals was entered on December 5, 1986, and amended on December 18, 1986. A petition for rehearing was denied on January 6, 1987 (Pet. App. A94-A95). The petition for a writ of certiorari was filed on March 6, 1987. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. The Medicare program, 42 U.S.C. (& Supp. III) 1395 *et seq.*, provides federal reimbursement for medical care provided to the aged and disabled. For the years at issue in this case, Medicare reimbursed hospitals for no more than the "reasonable cost" of covered services rendered to Medicare beneficiaries (42 U.S.C. (& Supp. III) 1395f(b), 1395x(v)(1)(A)). "Reasonable cost" is defined to include all necessary and proper costs incurred in rendering services to Medicare patients (42 C.F.R. 413.9 (1986)).[1] Capital-related costs such as interest on indebtedness or depreciation of assets used in patient care are generally considered an element of reasonable cost and may be reimbursed by the Medicare program (42 C.F.R. 413.130 (1986)).

Costs incurred in a transaction between related parties, including interest and depreciation, are subject to special limitations on reimbursement. A health care provider and another party are generally deemed to be "related parties" where there is com-

[1] The opinion below refers to the 1985 edition of the Code of Federal Regulations. Those regulations were redesignated without substantive change in 1986. See 51 Fed. Reg. 34790 (1986). We hereafter refer to both the 1985 and the 1986 codifications where appropriate.

mon ownership or control. Common ownership exists "if an individual or individuals possess significant ownership or equity" in the two organizations (42 C.F.R. 413.17(b)(2) (1986)). Control exists "if an individual or an organization has the power, directly or indirectly, significantly to influence or direct the actions or policies of an organization or institution" (42 C.F.R. 413.17(b)(3) (1986)).

As a general rule, when a health care provider receives goods or services from a related party, reimbursement is limited to the cost of the items to the related party; the price putatively paid by the provider is immaterial (42 C.F.R. 413.17 (1986), formerly codified at 42 C.F.R. 405.427 (1985)). With respect to interest expenses in particular, reimbursement is disallowed if the lender and the provider are related through common ownership, control, or personal relationship (42 C.F.R. 413.153(c) (1986), formerly codified at 42 C.F.R. 405.419(c) (1985)). Similarly, whereas a provider who purchases the assets of an ongoing business in a bona fide arm's-length transaction may take depreciation based on the current value of the purchased assets (42 C.F.R. 413.134(g) (1986)), reimbursable depreciation is more limited where a provider purchases assets from a related party. In a related-party transaction, depreciation expenses must be computed with reference to the *seller's* historical cost basis, minus accumulated depreciation (42 C.F.R. 413.134(g)(3) (1986), formerly codified at 42 C.F.R. 405.415(g)(3) (1985)). The purpose of these regulations is to limit federal reimbursement to reasonable costs that are actually and necessarily incurred by a health care provider, and to screen out artificially inflated cost claims that

may result from dealings between related parties. Pet. App. A9 & n.15.

2. Petitioner, an acute-care hospital, challenges the Secretary's denial of Medicare reimbursement for certain interest and depreciation expenses incurred in connection with its conversion in 1975 from a for-profit corporation to a non-profit corporation. The hospital was established in 1952 by the Monsour Hospital and Clinic, Inc., a Pennsylvania corporation whose stock was 100% owned by members of the Monsour family (Pet. App. A2). In 1975, the Monsour Medical Foundation, which had been established by the Monsour family in 1966, acquired the hospital from the family in a three-step transaction. The Foundation first purchased 3.5% of the family's stock for $500,000. The family members then donated additional stock to the Foundation. Finally, the hospital purchased the family members' remaining shares, via a stock redemption, for $7.5 million. This $7.5 million was represented by a 15-year installment note secured by a mortgage on the hospital's real estate holdings. *Id.* at A2-A3. The Foundation, which thus became the sole stockholder of the Monsour Hospital and Clinic, Inc., reorganized the hospital as a Pennsylvania non-profit corporation and renamed it the Monsour Medical Center, petitioner here.

After the conversion, petitioner sought Medicare reimbursement for the sizeable interest expenses that it incurred on the 1975 mortgage agreement with members of the Monsour family.[2] Petitioner also

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[2] After the first five years, the interest due on the note was pegged to the prime rate (Pet. App. A3). When interest rates rose in the late 1970's, "the hospital's monthly interest obligation under this note at various times doubled or even

sought reimbursement for depreciation on the acquired hospital assets, using a stepped-up basis derived from the 1975 sale rather than the private corporation's original cost basis. Petitioner initially received reimbursement for those costs through Blue Cross of Western Pennsylvania (Blue Cross), which, under contract with respondent Secretary, acted as the "fiscal intermediary" that reviewed and paid claims for Medicare reimbursement (42 U.S.C. (& Supp. III) 1395h; 42 C.F.R. 421.100 (1986)). See Pet. App. A4 & n.6. Blue Cross not only acted as a Medicare intermediary but also operated its own private health insurance program. In 1981, Blue Cross determined that the interest costs and higher depreciation expenses associated with the hospital's conversion were not reimbursable under its insurance program, because the conversion had been effected by related parties, not through an arm's-length transaction. The Secretary reached the same conclusion under the Medicare program. *Id.* at A4. Blue Cross subsequently disallowed claims for the costs in question.

In 1983, Blue Cross, "acting in its capacity as a private insurer" (Appellant's Br. 6), sued petitioner in Pennsylvania state court. Blue Cross sought, among other things, a declaratory judgment that the claimed capital-related costs of petitioner's conversion to non-profit status were not reimbursable. Petitioner counter-claimed for a contrary declaratory judgment. In 1983 the state court concluded that the conversion had occurred between unrelated parties and therefore

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tripled from the amounts it had previously been paying" (*id.* at A3 n.5). The hospital eventually encountered financial difficulties and was forced into bankruptcy (Pet. 6).

held that the interest and depreciation costs were reimbursable. See Pet. App. A5-A6, A69-A85, A86-A93. The state court reasoned: "It was never intended that control of the hospital continue in the Monsours subsequent to the conversion nor has such control continued in fact" (*id.* at A82). The Superior Court of Pennsylvania subsequently affirmed the trial court's decision (*id.* at A67-A68).

3. In 1983, petitioner challenged the Secretary's determination that the 1975 sale had been effected between related parties for purposes of the Medicare program.[3] Petitioner accordingly filed an appeal, pursuant to 42 U.S.C. (& Supp. III) 1395*oo*, with the Provider Reimbursement Review Board (PRRB or Board), an administrative tribunal empowered to review certain reimbursement determinations made by a Medicare fiscal intermediary. The Board concluded that the trustees of the Foundation that approved the acquisition of the hospital (all of whom were appointed by the Monsours) and the stockholders selling the hospital (the Monsours) were "related parties" within the meaning of the Medicare regulations. Pet. App. A54, A63-A64. The Board pointed out that the 1975 transaction was one "involving the sale of a for-profit hospital corporation's stock whereby the stockholders st[ood] to make a sizeable financial gain," and hence that the relatedness of the Monsours and the Foundation trustees whom they appointed must be judged by the rules that pertain in an ordinary commercial setting (*id.* at A64). The Board accordingly concluded that the Foundation

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[3] Petitioner challenged not only the interest and depreciation determinations but several other reimbursement decisions as well. Only the interest and depreciation claims are at issue in this Court. See Pet. App. A36-A37; Pet. 3 & n.3.

trustees acted as "surrogates of the [Monsour] Family" in approving the sale and that they had merely implemented a long-term plan that the Foundation had previously adopted when it was still formally controlled by the Monsour family (*id.* at A63). The Board's decision upholding Blue Cross's disallowance became final when the Secretary declined to review it. 42 U.S.C. (& Supp. III) 1395*oo*.

Petitioner challenged that decision in the United States District Court for the Western District of Pennsylvania. As a threshold matter, the court rejected petitioner's argument that the state court ruling against Blue Cross collaterally estopped the Secretary from litigating the "relatedness" issue under the Medicare program. Noting that, although Blue Cross and the Secretary had similar interests, there was no evidence that the Secretary directed or participated in the state court litigation (Pet. App. A27), the court found that the Secretary was neither a party nor in privity with Blue Cross in the state litigation. The court also questioned whether the Secretary could even have participated in the state court action without first exhausting the statutory review procedures set out in the Medicare statute (*ibid.*).

Turning to the merits, the court acknowledged that the issue before it (whether substantial evidence supported the Secretary's conclusion that the Monsours and the Foundation trustees were related parties) differed from the issue in the state litigation (whether Blue Cross established by a preponderance of the evidence that those persons were related parties). Pet. App. A28. Nevertheless, the district court, like the state court, ruled in favor of petitioner. The district court focused, as the state court had done (see *id.* at A5 n.9), on whether the Monsour family continued to control petitioner *after* the 1975 sale, and it

found no substantial evidence of such control in the record (*id.* at A31). The court consequently remanded the case to the Board with instructions to reimburse petitioner for the interest and depreciation costs (*id.* at A34).

4. The court of appeals unanimously reversed, holding that substantial evidence supported the Secretary's determination. The court first agreed that the state court decision against Blue Cross did not collaterally estop the Secretary from litigating the Medicare issue. After noting that the Secretary was obviously not a party to the state litigation, the court concluded that because the government did not exercise control over Blue Cross's conduct of the state court suit, it could not be estopped by that suit (Pet. App. A16, citing *Montana* v. *United States*, 440 U.S. 147 (1979)). The court pointed out that the Secretary had not required the suit to be filed, reviewed the complaint, paid attorneys' fees or costs, directed an appeal, appeared as amicus, or otherwise exercised control over the Blue Cross litigation (Pet. App. A16).

On the merits, the court of appeals upheld the Secretary's determination that the 1975 sale had occurred between related parties.[4] The court rejected the dis-

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[4] The PRRB, as an alternative basis for its decision, had ruled that the conversion involved the acquisition by the Foundation of stock rather than assets, and hence that interest and additional depreciation expenses arising out of the transaction were not reimbursable (Pet. App. A64-A65). See 42 C.F.R. 413.153(d)(1)(ii), 413.134(k) (1986). The district court concluded that this alternative holding was erroneous because the parties had stipulated before the Board that the stock-versus-asset question was not in dispute (Pet. App. A31). The court of appeals found no need to address the correctness of the district court's ruling in this respect, because it found the Board's related-parties holding to be supported by substantial evidence (*id.* at A13-A14 n.23).

trict court's focus on the parties' course of conduct during the years after the transaction was completed (Pet. App. A13-A15). Rather, the court of appeals held that a reasonable interpretation of the related-party regulations required an inquiry into the parties' status at the time of the sale, viz., in May 1975 (*id.* at A11-A13 & n.20). The court then concluded that the Board's determination that the parties were related at the time of the hospital conversion was supported by substantial evidence:

> Virtually all the factual evidence in the record before the PRRB establishes that the creation of the Foundation, the selection of its board members and trustees, and the financial transactions that effectuated the hospital conversion all proceeded according to the plans of, and were executed by, the members of the Monsour family who were the hospital's original (and only) stockholders.

Id. at A14. The court accordingly found "unequivocally" that the Secretary's decision was supported by substantial evidence (*id.* at A13).

ARGUMENT

The court of appeals' fact-specific decision is correct and is not in conflict with any decision of this Court or of any other court of appeals. Petitioner has not demonstrated that the issue it raises is of any general importance, and further review is unwarranted.

1. Petitioner first contends (Pet. 11-18) that the Pennsylvania court decision against Blue Cross collaterally estops the Secretary from establishing that the 1975 sale was effected between related parties. Petitioner points to no decision that holds, contrary to the court of appeals' decision here, that a ruling

against a Medicare fiscal intermediary, let alone one against the intermediary only in its distinct capacity as a private insurer, can have preclusive effect in any subsequent proceeding against the federal government. Moreover, although petitioner of necessity is arguing that the PRRB, and not just the courts below, erred in not holding the Secretary estopped on the related-party issue (see Pet. 11, 17),[5] petitioner identifies no decision of this Court that, without reference to specific statutes or regulations, requires administrative agencies to apply general preclusion law. Compare *University of Tennessee* v. *Elliott*, No. 85-588 (July 7, 1986) (administrative decisions may have preclusive effect in later court proceedings); *Chisholm* v. *Defense Logistics Agency*, 656 F.2d 42, 46 (3d Cir. 1981) (agency *permitted* to adopt preclusion principles). And petitioner points to no statute, decision, or regulation applicable to the PRRB in particular that requires it to apply preclusion principles (see generally 42 U.S.C. (& Supp. III) 1395*oo*; 42 C.F.R. Pt. 405, Subpt. R (1986)). In any event, even if one

[5] If petitioner is arguing only that the lower courts should have applied preclusion principles, preclusion was clearly improper because the issue in the federal suit was not the same as the issue in the state court suit. The federal courts had to decide whether the Board's decision was supported by substantial evidence; the state courts had to decide whether Blue Cross established relatedness by a preponderance of the evidence or, perhaps, simply whether the parties to the conversion were in fact related. See Pet. App. A28; *United States* v. *National Ass'n of Real Estate Boards*, 339 U.S. 485 (1950) (failure to meet higher burden of proof does not preclude attempt to meet lower burden); *Hospital Corporation of America* v. *FTC*, 807 F.2d 1381, 1384-1385 (7th Cir. 1986), cert. denied, No. 86-1492 (May 4, 1987) (substantial evidence review more deferential than independent inquiry into facts found by agency).

assumes that the Board was obligated to apply general preclusion principles, the court of appeals' decision is correct.

A judicial decision on an issue precludes relitigation of the same issue only by parties to the suit and certain non-parties often described as "privies." See *Montana* v. *United States*, 440 U.S. at 153-154.[6] This Court held in *Montana* that the United States was in privity with a party "whose litigation had been totally financed and controlled by the Federal Government" (*United States* v. *Mendoza*, 464 U.S. 154, 159 n.5, 164 n.9 (1984)). Here, the Secretary obviously was not a party to the state court suit against Blue Cross. Nor did the Secretary exercise control over or finance the state court suit: indeed, as the court of appeals explained (Pet. App. A16), none of the indicia of control identified by this Court in *Montana* is present in this case. Petitioner does not contest these facts or point to any decision of this Court other than *Mon-*

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[6] In *Montana*, this Court applied federal common law preclusion principles, rather than state preclusion law, in determining whether, as here, the federal government could be collaterally estopped by a state court suit. 440 U.S. at 153-155. The court of appeals in this case likewise applied federal law; and petitioner, although it mentions the issue (Pet. 12 n.6), does not challenge the court of appeals' approach in the petition (see Pet. i (Questions Presented)). We accordingly assume that federal law governs here.

We note that the full faith and credit statute, 28 U.S.C. 1738, which presumptively requires application of Pennsylvania preclusion law to determine the effect in a "court" of a Pennsylvania court decision (*Marrese* v. *American Academy of Orthopaedic Surgeons*, 470 U.S. 373 (1985)), by its terms does not require an administrative agency like the PRRB to apply state preclusion law. In any event, as noted below (note 7, *infra*), Pennsylvania preclusion principles would lead to the same result as federal principles.

tana in which the federal government has been held subject to non-party preclusion.

Lacking support in this Court's precedent, petitioner suggests that the government is collaterally estopped here on the theory that its interests were identical to those of Blue Cross (Pet. 15) and therefore "were sufficiently represented by a similarly-situated party in [the] prior proceeding" (*id.* at 14, 15). This suggestion misunderstands the doctrine of "representation" under which non-party preclusion has been permitted. The doctrine requires more than mere coincidence of interests; it requires that the party have actually represented the non-party's interests and, by virtue of actual control or legal obligation (perhaps inherent in a special relationship like that between family members), that the party have been legally accountable for representing the non-party's interests. See *United States* v. *ITT Rayonier, Inc.*, 627 F.2d 996, 1003 (9th Cir. 1980) ("virtual representative" doctrine "contemplates an express or implied legal relationship by which parties to the first suit are accountable to non-parties * * * [in] a subsequent suit with identical issues"); *Sea-Land Services* v. *Gaudet*, 414 U.S. 573, 593 (1974) (non-party may be collaterally estopped where litigating party acts in a fiduciary capacity); *Ethnic Employees of Library of Congress* v. *Boorstin*, 751 F.2d 1405, 1410-1411 & n.8 (D.C. Cir. 1985); *Pollard* v. *Cockrell*, 578 F.2d 1002, 1008-1009 (5th Cir. 1978); see generally 18 C. Wright, A. Miller & E. Cooper, *Federal Practice and Procedure* § 4457 (1981); Restatement (Second) of Judgments § 41 (1982). Even petitioner acknowledges that Blue Cross had no legal obligation to act as the Secretary's representative in the state court suit and did not in fact do so. Blue Cross litigated that

suit, as petitioner stated in the court of appeals, "in its capacity as a private insurer" (Appellant's Br. 6).[7]

In addition, application of the doctrine of representation to the government, even if one assumes arguendo that it could ever be appropriate,[8] would be

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[7] Under Pennsylvania rules of preclusion, which require "privity" for non-party preclusion (*Safeguard Mutual Insurance Co.* v. *Williams*, 463 Pa. 567, 574, 345 A.2d 664, 668 (1975)), the Secretary would likewise not be bound by the ruling against Blue Cross. The Secretary did not have the required "full and fair opportunity to litigate the issue" in the state court suit (*ibid.*). Moreover, "[t]o be concluded by a prior decree or judgment one must be a party to the action, or what is equivalent thereto with a right to control the proceedings and take an appeal." *Albert* v. *Lehigh Coal & Navigation Co.*, 431 Pa. 600, 612, 246 A.2d 840, 846 (1968). The court of appeals found no basis for concluding that the United States had control over Blue Cross's state court litigation, and petitioner advances no reason for overturning that fact-bound determination.

[8] In *United States* v. *Mendoza*, *supra*, this Court held that a decision against the federal government in one suit could not be invoked by a person not a party to that suit to estop the government collaterally in a later suit. For reasons similar to those relied on by the Court in *Mendoza*, we question whether non-party preclusion should ever be invoked against the government in the absence of actual control by the government of the first proceeding. The government's interests in the resolution of legal issues are too extensive and consequential, and subject to too many distinctive considerations (see 464 U.S. at 159-163), to permit the government to be bound by litigation decisions that it has not itself made.

In *United States* v. *ITT Rayonier, Inc.*, *supra*, relied on by petitioner (Pet. 13), the Ninth Circuit held that the United States was precluded from raising an issue litigated by a state agency. We question the correctness of that decision. In any event, the decision turned on a highly fact-specific analysis of the relationship between the state agency's authortiy to enforce a pollution discharge permit and the closely

plainly inappropriate in this case. The Medicare statute establishes a detailed set of procedures for obtaining administrative and federal court review of Medicare reimbursement determinations, procedures that give due regard to agency expertise in the administration of the Medicare program. See 42 U.S.C. (& Supp. III) 1395*oo*. Petitioner's argument would permit those carefully crafted procedures to be circumvented by litigating private insurance reimbursement issues in state court and then asserting that the state court determinations have collateral estoppel effect on federal review of similar issues arising in the Medicare program. As the district court said in rejecting petitioner's collateral estoppel claim, "[s]erious questions remain concerning whether Medicare could have participated in the state court hearing without exhausting federal procedures under the Social Security Act" (Pet. App. A27).

2. Petitioner also contends (Pet. 18-22) that the court of appeals erred in concluding that substantial

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related authority of the Environmental Protection Agency (EPA) to enforce the same permit. The first proceeding was an enforcement action brought by the state agency in the exercise of federally granted and revocable permit-enforcement power, and the action was brought only after "the EPA's prompting that absent state action [the defendant] was a candidate for federal enforcement" (627 F.2d at 1003). The second proceeding was an EPA action to enforce the same permit, and that action, though it could have been filed at any time, was not filed until after an initial adverse state court ruling (*id.* at 999). Of course, the statutory scheme at issue in *ITT Rayonier* is not at issue here. Moreover, Blue Cross was litigating its private insurance interests in its state court suit, not the Secretary's interests; and this case does not involve a government-initiated suit, let alone one that could have been filed earlier but was in fact initiated only after a setback in earlier, government-prompted litigation.

evidence supported the PRRB's finding that the 1975 sale of the hospital was effected between related parties. This contention is fact-specific and is without merit. The court of appeals properly deferred to the Secretary's patently reasonable interpretation of his related-party regulations (42 C.F.R. 413.17(b), 413.153(c), 413.134(g)(3) (1986)) as focusing on the Monsours' power to control or influence the Foundation at the time of the sale (Pet. App. A10-A15). This focus on the relationship that exists at the time of the challenged transaction is wholly consistent with the rulings of other courts on this issue, including the decisions cited by petitioner (Pet. 19). See, *e.g.*, *Medical Center of Independence* v. *Harris*, 628 F.2d 1113, 1116-1119 (8th Cir. 1980); *Goleta Valley Community Hospital* v. *Schweiker*, 647 F.2d 894, 896-897 (9th Cir. 1981); *Hospital Affiliates International, Inc.* v. *Schweiker*, 543 F. Supp. 1380, 1386-1387 (E.D. Tenn. 1982); cf. *Pacific Coast Medical Enterprises* v. *Harris*, 633 F.2d 123, 134 (9th Cir. 1980) (related-party regulation does not apply to acquisition of assets where parties were engaged in arm's-length dealings at the time of the acquisition). Contrary to petitioner's suggestion (Pet. 19), moreover, factors like majority ownership and day-to-day operating control are not the sole indicators of a transaction between related parties. Relatedness may stem from "personal" as well as juridical relationships (42 C.F.R. 405.419(b)(3)(ii) (1985)), and the relationship need only be close enough so that one party has "the power, directly or indirectly, significantly to influence" the actions of the other. See 42 C.F.R. 413.17(b)(3) (1986); *Chelsea Community Hospital* v. *United States*, 2 Cl. Ct. 175, 181 (1983); *Marina Mercy Hospital* v. *Harris*, 633 F.2d 1301, 1303 (9th Cir. 1980).

Finally, petitioner is wrong in asserting (Pet. 20) that the court of appeals refused to consider evidence post-dating the 1975 sale and affirmed the Board's finding simply because the conversion went as the Monsours had planned it. The court of appeals specifically declined to rely on the simple "syllogism" that petitioner challenges (Pet. App. A13 n.22). The court merely held that, in the circumstances surrounding the particular transaction at issue here, including the facts that the Monsours created the Foundation, appointed all of its trustees, and planned the conversion, there was "powerful and substantial evidence of the Monsours' continuing power to influence the Foundation at the time in question" (*id.* at A15). The court of appeals' ruling is not in conflict with decisions indicating that all the circumstances surrounding the transaction are relevant to the relatedness inquiry (see, *e.g.*, *Shaker Medical Center Hospital* v. *Secretary of HHS*, 686 F.2d 1203 (6th Cir. 1982); *Bellwood General Hospital* v. *Schweiker*, 673 F.2d 1043 (9th Cir. 1982)).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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